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CENTRAL INTELLIGENCE AGENCY
Office of Current Intelligence
2 August 1963

CURRENT INTELLIGENCE MEMORANDUM

SUBJECT: Political and Economic Conditions in
Ceylon

1. The effects of the US aid suspension in February have not been decisive in either political or economic terms. While the US action, as a part of the whole question of compensation for the Western oil companies, has figured importantly in political developments of the past six months, internal political pressures on the regime which have been building up for more than a year have largely governed the state of Ceylon's relations with the US. In economic terms, the aid cut-off has had even less impact, mainly because the development grants and loans affected amounted to no more than \$4 million. This loss, moreover, has been temporarily offset by an upturn in foreign exchange earnings.

2. Prime Minister Bandaranaike's position is weaker than at any time since she took office following an impressive election victory three years ago. She has been increasingly threatened by factionalism within her left-of-center Sri Lanka Freedom Party (SLFP), growing popular support for the conservative United National Party (UNP), and greater unity among the three opposition parties on the extreme left.

3. The aid suspension provided a convenient rallying point for leaders of Ceylon's three Marxist parties, which had done poorly in municipal elections in late 1962. Exploiting the upsurge of anti-American sentiment following the cut-off, the Marxists were able to gloss over deep and long-standing political differences and by establishing in May a United Leftist Front (ULF). Party leaders have not yet agreed upon a common program or joint leadership, and negotiations continue on both

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questions. While the long-term effectiveness of the ULF is likely to be limited by the leaders' inability to submerge their bitter personal rivalries, the Marxists have registered a moderate increase in strength in several recent municipal elections.

4. Whatever the actual strength of the leftist front may be, Mrs. Bandaranaike has become convinced that it poses a major threat to her government. Fearing a defection to the ULF by left-wing members of her parliamentary party--which could imperil her slim parliamentary majority--the Prime Minister has permitted a slight drift further leftward in her government's policies. Her acquiescence in the recent decision to take over the distribution of petroleum from Western companies by 1 January 1964 and her unwillingness to compromise with the firms on the issue of compensation for properties already appropriated stem largely from her reluctance to alienate these leftist elements.

5. At the other end of the political spectrum, the conservative UNP, led by Dudley Senanayake, appears to be weaning substantial popular support away from ~~the~~ Mrs. Bandaranaike's SLFP. Strongly critical of the ineptness of the government's economic policies, the UNP appears to be benefiting from its glaring mismanagement and corruption in nationalized enterprises.

6. The recent improvement in Ceylon's foreign exchange position results largely from a rise--probably temporary--in export earnings and from stringent government restrictions on imports. The island's long-term economic problems--the generally downward trend of world prices for Ceylon's export commodities--tea, rubber, coconut--dangerously low foreign exchange reserves, increasing unemployment, and a growth rate too low to keep ahead of population--remain unsolved.

7. The Bandaranaike government's economic policies have aggravated rather than alleviated these problems. Extensive price subsidies and uneconomic public undertakings have led to large budget deficits, generating strong inflationary pressures. The government allowed these pressures to be absorbed through drawing down foreign exchange reserves to finance consumer imports until reserves reached a dangerously

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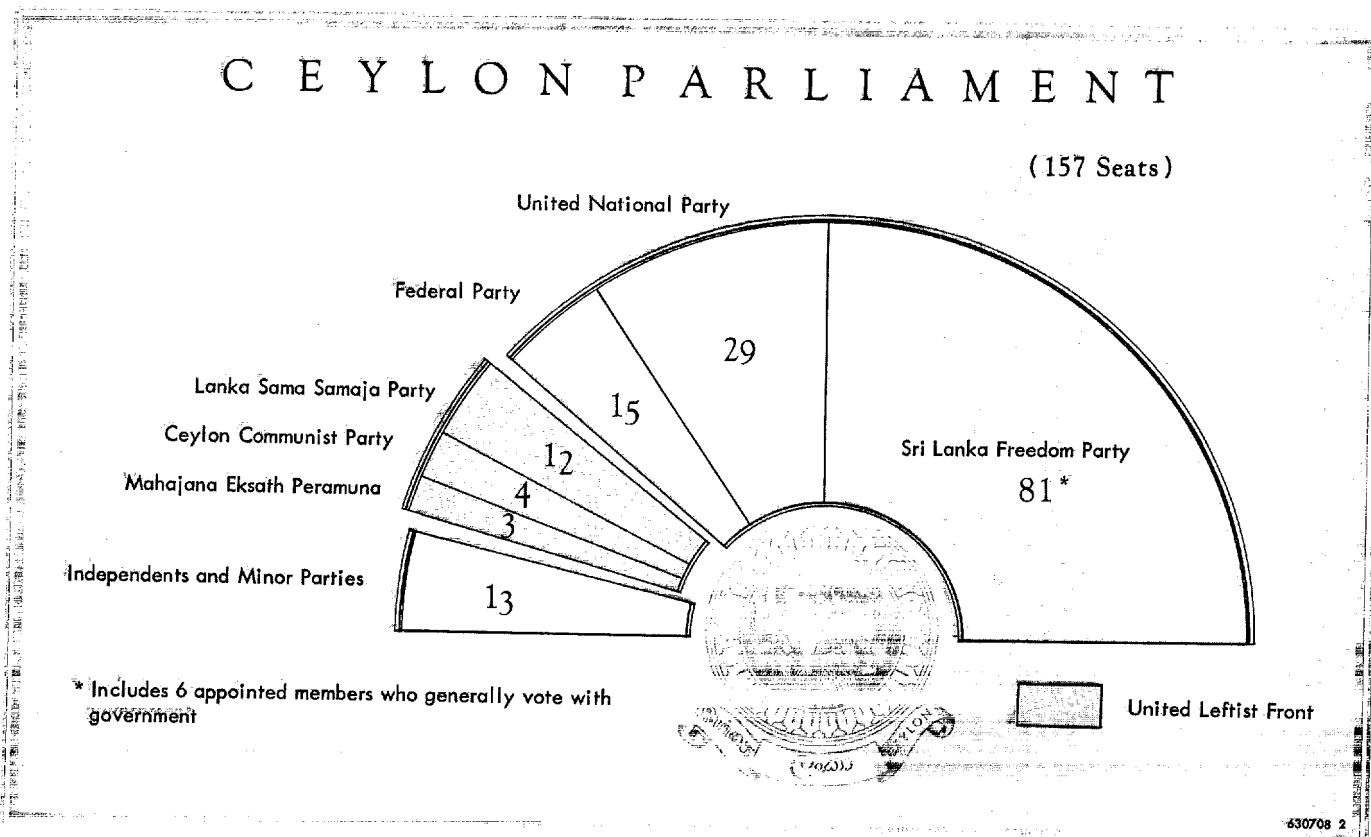
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low point last year. The government then imposed import restrictions which resulted in a sharp price rise.

8. Beset by economic and political difficulties, the government is reduced to fighting a holding action during the current session of Parliament. Its program for the coming year, presented on 17 July, and described as one of "consolidation," avoided all controversial issues. Mrs. Bandaranaike managed to win a confidence vote on it on 31 July. However, she still faces a crucial vote later this month on the budget prepared by anti-West Finance Minister Ilangaratne. Anxious to retain the support of all factions of her party, she is unlikely to propose the politically dangerous austerity measures required to ease Ceylon's economic problems.

9. On balance, it appears likely that Mrs. Bandaranaike will survive the budget vote by a narrow margin, in part because the SLFP dissidents are reluctant to force elections which they fear the right-wing UNP would win. Political problems will continue to plague the SLFP, however, and the government's shaky position is unlikely to improve in the near future. Under these circumstances, little progress on the compensation issue can be expected. The question of US aid is likely to remain a political ~~footnote~~
ball, but not a decisive political factor.

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MRS. BANDARANAIKE



ILANGARATNE



SENANAYAKE